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Macroeconomic co-ordination as an economic policy concept – opportunities and obstacles in the EMU

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Macroeconomic co-ordination as an economic policy concept – opportunities and obstacles in the EMU[*]

Eckhard Hein and Achim Truger

Abstract

This paper traces the euro zone's inadequate macroeconomic performance in recent years back to the predominance of a restrictive macroeconomic policy mix based on a 'new monetarist' approach to economic policy. An approach based on a (post-)Keynesian analysis is presented as a growth and employment-oriented alternative to this restrictive policy mix. Contrary to the strict assignment of macroeconomic goals to the macroeconomic policy actors and their instruments in the 'new monetarist' approach, the alternative requires the co-ordination of monetary, fiscal and wage policies in order to achieve growth, high employment and price stability. The paper examines the opportunities for and the obstacles to macroeconomic co-ordination given by the institutional framework of the European Monetary Union.

JEL classification: E61, E63, E64, E65

Keywords: Macroeconomic policy co-ordination, European Monetary Union, monetary policy, fiscal policy, wages policy

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1. Introduction

After three years of economic stagnation across the member states of the European Monetary Union (EMU), the EU Commission is currently forecasting for 2004 only moderate growth of approximately 1.8% in real gross domestic product (GDP) within the EMU. Consequently, the unemployment rate for 2004 will once again climb above 9%, having fallen below 8% in 2001.[1] Clearly, then, even since the creation of the EMU it has not been possible to achieve the higher rates of economic growth in Europe which would lead to a significant cut in the high rate of unemployment. Whereas the average annual real GDP growth rate in the US in the 1990s was running at 3.2%, and unemployment for the same period fell to an average of 5.6%, annual real GDP growth in the countries of the EMU dropped from an already meagre 2.4% in the 1980s to an average of 2.1% in the 1990s. Unemployment rose correspondingly from an average of 8.6% in the 1980s to 9.8% in the 1990s. Even after the slump in growth in 2001, the GDP growth rate in the United States of over 2.5% is now once again appreciably higher than in the EMU.

Table 1: Real GDP growth rates for EMU countries and the US, 1999 - 2004 (in %)

	1999	**2000**	**2001**	**2002**	**2003***	**2004***
Belgium	3.2	3.8	0.6	0.7	0.8	1.8
Germany	2.0	2.9	0.8	0.2	0	1.6
Greece	3.4	4.4	4.0	3.8	4.1	4.2
Spain	4.2	4.2	2.8	2.0	2.3	2.9
France	3.2	3.8	2.1	1.2	0.1	1.7
Ireland	11.3	10.1	6.2	6.9	1.6	3.7
Italy	1.7	3.1	1.8	0.4	0.3	1.5
Luxembourg	7.8	9.1	1.2	1.3	1.2	1.9
Netherlands	4.0	3.5	1.2	0.2	-0.9	0.6
Austria	2.7	3.4	0.8	1.4	0.9	1.9
Portugal	3.8	3.7	1.6	0.4	-0.8	1.0
Finland	3.4	5.1	1.2	2.2	1.5	2.5
EU-12	**2.8**	**3.5**	**1.6**	**0.9**	**0.4**	**1.8**
USA	4.1	3.8	0.3	2.5	2.8	3.8

Notes: * European Commission forecast
Source: European Commission (2003)

[1] For all of the following figures, see European Commission (2003). In the most recent European Commission publication (2003) unemployment figures relate only to eleven of the twelve EMU countries, since Greece is not included.

Table 2: Unemployment rates in EMU countries and in the US, 1999 - 2004 (in %)

	1999	2000	2001	2002	2003*	2004*
Belgium	8.6	6.9	6.7	7.3	8.2	8.3
Germany	8.4	7.8	7.8	8.6	9.4	9.6
Greece	11.8	11.0	10.4	10.0	9.5	9.2
Spain	12.8	11.3	10.6	11.3	11.3	10.9
France	10.7	9.3	8.5	8.8	9.4	9.7
Ireland	5.6	4.3	3.9	4.4	4.8	5.1
Italy	11.3	10.4	9.4	9.0	8.8	8.8
Luxembourg	2.4	2.3	2.1	2.8	3.7	4.2
Netherlands	3.2	2.8	2.4	2.7	4.4	5.8
Austria	3.9	3.7	4.1	5.1	6.6	7.2
Portugal	4.5	4.1	4.1	5.1	6.6	7.2
Finland	10.2	9.8	9.1	9.1	9.3	9.2
EU-11[#]	**9.3**	**8.4**	**7.9**	**8.3**	**8.9**	**9.1**
USA	4.2	4.0	4.8	5.8	6.1	6.2

Notes: * European Commission forecast, [#] EMU excluding Greece
Source: European Commission (2003)

As can be seen from Tables 1 and 2, however, this unsatisfactory growth and jobs performance within the EMU as a whole is not applicable to each individual country. Whilst the EMU convergence process of the 1990s succeeded to a considerable degree in closing the gap between member states' nominal variables (short and long-term nominal interest rates, inflation rates and deficit ratios), real variables (GDP growth, output gap, unemployment rate, and labour productivity) tended to diverge.[2]

Table 3: Total government budget surplus (+) or deficit (-) (as % of GDP) in EMU countries and in the US, 1999-2004

	1999	2000	2001	2002	2003*	2004*
Belgium	-0.4	0.2	0.6	0.1	0.2	-0.4
Germany	-1.5	1.3	-2.8	***-3.5***	***-4.2***	***-3.9***
Greece	-1.8	-1.9	-1.5	-1.2	-1.7	-2.4
Spain	-1.2	-0.8	-0.3	0.1	0	0.1
France	-1.8	-1.4	-1.5	***-3.1***	***-4.2***	***-3.8***
Ireland	2.4	4.4	0.9	-0.2	-0.9	-1.2
Italy	-1.7	-0.6	-2.6	-2.3	-2.6	-2.8
Luxembourg	3.5	6.4	6.2	2.4	-0.6	-2.1
Netherlands	0.7	2.2	0	-1.6	-2.6	-2.7
Austria	-2.3	-1.5	0.3	-0.2	-1.0	-0.6
Portugal	-2.8	-2.8	***-4.2***	-2.7	-2.9	***-3.3***
Finland	2.2	7.1	5.2	4.2	2.4	1.7
EU-12	**-1.3**	**0.2**	**-1.6**	**-2.2**	**-2.8**	**-2.7**
USA	0.7	1.5	-0.5	-3.4	-5.0	-5.5

Notes: *European Commission forecast
Source: European Commission (2003)

[2] For further details see Hein/Truger (2004).

In the meantime, this real divergence is also having repercussions on the dispersion of deficit ratios. Following the marked reduction, in the run-up to European Monetary Union, towards the Maastricht Treaty's goal of a current public budget deficit of less than 3% of GDP, now the larger member states in particular, are experiencing considerable difficulty in keeping to the deficit target (Table 3). For the third year in succession Germany and France will fail to attain the deficit target in 2004 and as a result are already subject to the excessive deficit procedure of the European Commission and the ECOFIN Council. As in 2001, Portugal's budget deficit for 2004 will also be too high.

In the course of this contribution we shall explain that after almost five years of EMU, real economic stagnation and the failure to achieve convergence are essentially the product of a restrictive macroeconomic policy mix. In the second section, we shall begin by setting out in brief the direction taken by monetary, fiscal and wages policy in the context of the EMU's institutional framework, before going on to demonstrate that these policies have been guided by 'new monetarist' notions of a clear economic policy assignment. The third section will then present alternatives for a more expansive macroeconomic policy mix based on a (post-)Keynesian approach to macroeconomics. Since these alternatives require the various players to implement a co-ordinated expansive macroeconomic policy in which monetary, fiscal and wages policy share responsibility for growth, employment and price stability, the extent to which it is possible to implement such a policy mix within the institutional framework of the EMU is also discussed. Section 4 briefly draws the following conclusions: the current institutions may not be ideal for achieving a more expansive policy mix, but with an appropriate appreciation of the macroeconomic context (which could even be brought about by means of political pressure) the relevant players will nevertheless find considerable scope for pursuing policies which are more growth and employment-friendly.

2. The restrictive macroeconomic policy mix of the Maastricht Assignment

The current policy mix in the EMU, characterised by the 'Maastricht Assignment' (Issing 2002), follows a concept which can be described as 'new monetarist' in line with Arestis et al. (2001) and which in theory derives from a blend of monetarist, neo-classical and new-Keynesian economic policy assignment (Hein 2002). This concept can be summarised in four points:

1. In the long term, the private sector is stable, and both Say's Law (i.e. every supply produced under least-cost conditions will find a demand) and the classical dichotomy between the real and the nominal sphere apply. Discretionary economic policy has a destabilising effect. As a result, economic policy decisions must be made largely independent of the political regime of the day and must be subject to clear rules.
2. Inflation is exclusively a monetary phenomenon. The role of independent central banks is therefore purely to maintain price stability. By using interest rate policy they can control the inflation rate without real economic costs.
3. Unemployment fluctuates around an equilibrium level, the NAIRU, which is determined by supply-side factors. The NAIRU (Non-Accelerating Inflation Rate of Unemployment) can be reduced by introducing greater flexibility into the labour market, but it remains independent of effective demand on commodity markets.
4. Fiscal policy has no long-term effect on growth and employment and should therefore play a subordinate role to the goal of price level stability. Within the context of the economic cycle, however, it should passively accept budget surpluses and deficits.

This policy approach forms the basis of all the key economic policy regulations of the EMU.[3] Thus, for example, the Broad Economic Policy Guidelines (BEPG) as the central 'co-ordination instrument' of economic policy in the EU (EC Treaty, Art. 99) which are drafted by the Commission, debated by the ECOFIN Council and approved annually by the European Council regularly stipulate a clear assignment of the players involved and the tools at their disposal to the economic policy targets as outlined in the 'new monetarist' approach. This serves to supporting the ECB in carrying out its primary function – the creation of price stability. The job of fiscal policy, meanwhile, is to achieve a supercyclically balanced budget. Finally, there are a number of recommendations designed to reduce unemployment: the creation of more flexible labour markets; the differentiation of real wages and their alignment with workplace productivity by means of decentralising wage bargaining; increasing the incentives for people to enter employment as well as increasing the mobility of the workforce.[4]

[3] See European Commission (2002) and Hein (2003) for a more detailed presentation of the economic institutions of the EMU.
[4] See the recent recommendations by the Commission for the Broad Economic Policy Guidelines during the period 2003 to 2005 (European Commission 2003a). In a phase of under-utilised capacity and high European

Implicit or explicit ex ante co-ordination, in which the macropolitical players take joint responsibility for growth, employment and price stability on account of the interdependence of the instruments they deploy, is foreign to this policy approach. Ex ante co-ordination is actually explicitly rejected by one of the key players, the ECB, with the emphasis instead being on clearly defined competences and responsibilities (Issing 2002).

The macroeconomic policy pursued since 1999 in the EMU is distinguished not only by its clear assignment of goals and instruments to the macropolitical players in line with the 'new monetarist' approach, but also by an asymmetrical degree of centralisation and co-ordination of individual policies within the euro zone.[5] This gives rise to considerable problems for macroeconomic performance in the EMU.

2.1 Monetary policy

Monetary policy in the EMU has been in the hands of the euro system since 1999, with the ECB at its head (EC Treaty, Art. 105-115). However, the exchange rate regime is established by the European Council after consultation with the ECB (EC Treaty, Art. 111). The primary objective of the ECB is to guarantee price stability (EC Treaty, Art. 105). Provided that achievement of this goal is not compromised, however, the ECB also has a remit to support general economic policy in realising the tasks of the Community, for example, to help to bring about a high level of employment and sustained, non-inflationary growth (EC Treaty, Art. 2). However, the ECB sees its contribution to high employment and growth as beginning and ending with the creation of price stability:

"Instead, by maintaining price stability over the medium term, the single monetary policy makes the best contribution it can to achieving sustainable non-inflationary growth and a high level of employment, thereby supporting the general economic policies in the Community, as required by the Treaty." (Issing 2002, p. 351)

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unemployment the focus here is on economic reforms to increase the growth potential in Europe and improvements to sustainability of public finances.

[5] See Hein/Truger (2004) for further analysis of the macroeconomic regime of the EMU and its effects on convergence and growth.

The ECB is politically and economically independent and is also independent in terms of goals and instruments (EC Treaty, Art. 108). In its monetary policy strategy formulated in 1998, it considers its primary goal of price stability to have been achieved if the Harmonised Consumer Price Index (HCPI) increases at a rate of less than 2% per annum in the medium term (ECB 1999). This inflation target represents a very restrictive definition of price stability (Heine/Herr 2001). On the one hand, the price index exaggerates the actual rate of inflation because it fails to take account of quality improvements and substitution processes, with the result that in practice a much lower inflation rate is targeted. Furthermore, sustained upturns in OECD countries have in the past always gone hand in hand with inflation rates above 2%. Even the Federal Republic of Germany, the former key currency country in the European Monetary System (EMS), recorded an inflation rate significantly higher than 2% over the long term.[6] By setting the inflation target at "below 2%", the ECB is also making it clear that it is not aiming to control inflation symmetrically by combating in equal measure any deviation upwards or downwards from the medium-term inflation target, but favours instead an asymmetrical approach geared to preventing only upward deviations. During the review of the monetary policy strategy carried out in May 2003, the ECB (2003) made it clear that it intended to continue with its restrictive inflation target. Now, however, it specified that there be a "medium-term focus for monetary policy on inflation rates below, but close to, 2%" (ECB 2003, p. 93), believing that this is sufficient to guard against any risk of deflation.

The ECB's 1998 monetary policy strategy was based on a two-pillar strategy. The first pillar made provision for a reference value for growth of the money supply (M3). The second pillar took account of a number of factors which influence future price trends (wages, exchange rates, bond prices, interest rate structure, real economic activity, fiscal indicators, price and cost indexes, as well as business and consumer surveys). This combination of elements of, on the one hand, a monetarism-inspired control of the money supply, which defines inflation as a 'monetary phenomenon' that can be overcome by adequate control of the money supply, and on the other a Keynesianism-influenced direct inflation targeting, which assumes an endogenous money supply not under the direct control of the central bank and which shifts the causes of inflation instead to the commodity and labour markets, has contributed to the development of a monetary policy strategy which is less than transparent and at times even

[6] The average annual growth rate in the consumer price index in Germany in the 1970s was 5.1%, falling to 2.5% in the 1980s and 2.3% in the 1990s.

contradictory (Heine/Herr 2002).[7] During the reform of its monetary policy strategy, the ECB (2003) reduced the importance of the reference value for growth of the money supply by moving monetary analysis to the second pillar. The bank also decided not to give annual reference values for the growth of the money supply. In addition, the ECB emphasised the importance of real economic determinants for inflation, in as far as their analysis now became the first pillar of monetary strategy. The ECB has thus increasingly moved towards a strategy of inflation targeting, such as is currently being practised by a number of major central banks (Meyer 2001).

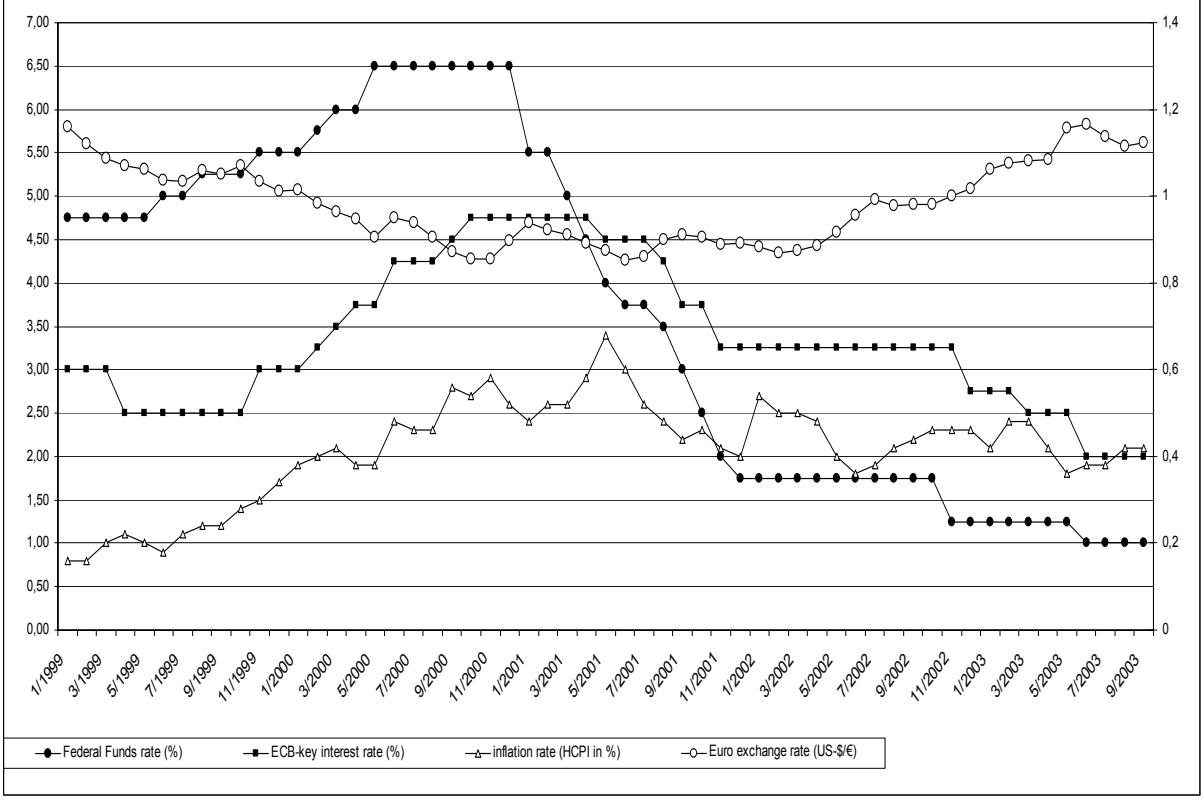
Certain detailed studies show that in the early years of the EMU the policies of the ECB were characterised by an 'anti-growth bias' (Bibow 2002).[8] The ECB did not follow the symmetrical strategy of the US Federal Reserve (Fed), whose policies are considered by many observers to be responsible for the sustained upturn in the US during the 1990s and which even after the recession in 2001 enabled significantly higher growth rates to be achieved in the US than in the euro zone.[9] Instead, the ECB took an asymmetrical approach to combating imminent inflation risks, failing to stimulate growth and employment in phases during which there was no risk of rising inflation (Allsopp/Artis 2003).

As can be seen from Figure 1, in 1999 the US Federal Reserve began raising the key interest rate step by step in order to slow down the share price inflation which accompanied the high GDP growth rates in the second half of the 1990s. When the key interest rate reached a peak of 6.5% in 2000, the Fed effectively triggered an economic downturn in the following year. Despite slower growth in the euro zone, the ECB followed the Fed's policy of raising interest rates from the end of 1999 onwards. In one year it raised the key interest rate from 2.5% to 4.75%, and in so doing prevented the euro zone from taking over from the US economy as the engine of global economic activity.[10] When there was a global slump in GDP growth, the Fed

[7] These contradictions have a tendency to occur whenever the underlying money supply changes as a result of a restructuring of portfolios, without these influencing in any way inflation potential on the commodities markets, i.e. when there are significant fluctuations in the velocity of circulation.
[8] See Bibow (2002, 2003), Hein (2002a).
[9] See Flassbeck (2001), Kalmbach (2000), Schulmeister (2001), Solow (2000).
[10] For a more detailed assessment of the contribution made by ECB policy to the recession of 2001 see Bibow (2003). If this policy was based on an orientation towards the exchange rate by the ECB, as suggested by Heine/Herr (2002), then it was counterproductive (Bibow 2002). A restrictive monetary policy clouded the prospects for growth in the euro zone, reduced forecast profitability and thus the demand for assets issued within the euro zone and as such did little to aid the recovery of the external value of the euro as determined by the international financial markets. There was no upward revaluation of the euro until in the US growth prospects

then began to make significant cuts in its key interest rate from as early as January 2001, continuing to lower it over the course of the next twelve months, until by the end of the year it had fallen from 6.5% to 1.75%, a drop of 4.75 percentage points. The ECB, on the other hand, waited until May 2001, when it was really no longer possible to deny the downturn, before reducing the key interest rate in four small steps from 4.75% to 3.25% by the end of the year, i.e. by just 1.5 percentage points. And in 2002 the ECB refused to lower the key interest rate further – despite ever more distant prospects of an economic upturn – until the very end of the year, when in December 2002 the rate was trimmed back by a further 0.5 percentage points.

Figure 1: Federal Funds rate, ECB-interest rate, Euro-exchange rate, and inflation rate in the EMU
Source: ECB (2003), Federal Reserve Bank of New York (2003)



More emphatic interest rate cuts were rejected because the inflation rate was above the medium-term target of less than 2%. As in previous years, however, the failure to meet the inflation target was not due to excessive nominal wage growth, which would have had to be combated by means of a restrictive monetary policy, but to exogenous shocks, i.e. the rise in the price of imported crude oil products and the devaluation of the euro, as well as the rise in

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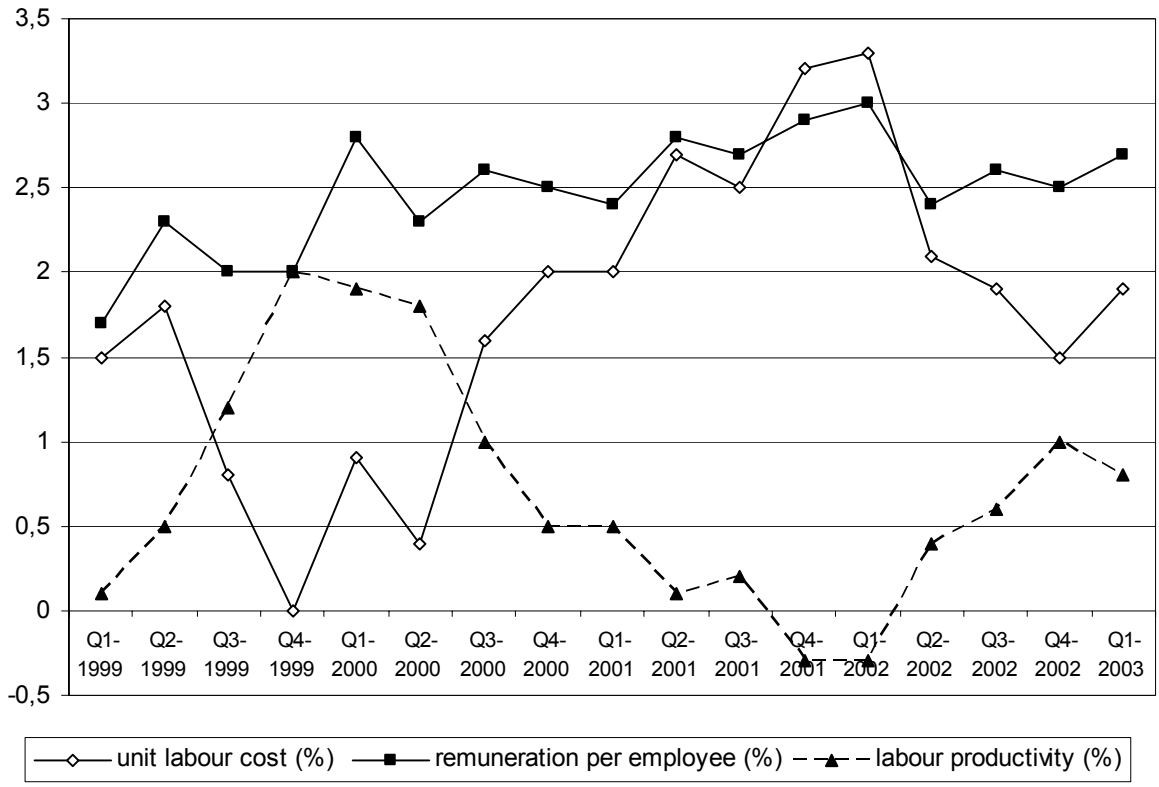
also began to cloud from 2001 onwards, share prices fell back sharply and uncertainty increased as a result of the

the price of food as a result of animal diseases. Monetary policy would have been able to passively accept the one-off surge in prices associated with these events, however, so long as wages policy did not lead to any second round effects. And this had not been the case since the start of monetary union. Nominal wage rates rose moderately at between 2% and 3%, and the rise of unit labour costs by over 2% in 2001 was brought about by the cyclical decline in productivity against the background of a downturn in growth, which was itself a product of monetary policy (Figure 2). Also the two small ECB interest rate cuts totalling 0.75 percentage points in 2003 did not succeed in stimulating the stagnating real economy and were at best no more than a compensation for the revaluation of the euro which had taken place over the same period.

Figure 2: Unit labour cost, remuneration per employee, and labour productivity in the EMU, 1999/1 - 2003/1, annual growth rate (in %)
Source: ECB (2003)



Some observers applying a Taylor rule consider the ECB policy to be entirely appropriate and even rather too expansive in some phases (see, for example, SVR 2003). But using a Taylor

September 11 attacks and various corporate American accounting scandals.

rule implies accepting the ECB's overly restrictive inflation target and the excessively modest assumptions with regard to potential growth. Furthermore, it is unclear whether the equilibrium real interest rate on which the Taylor rule is based is really independent of the monetary interest rate which is decisively influenced by monetary policy. Therefore, even if the ECB follows a Taylor rule, this does not mean that the criticism of an 'anti-growth-bias' is unjustified. This 'anti-growth-bias' of the ECB will have even more serious effects in the future, since the expansive one-off effects which came about for the majority of EMU countries during the second half of the 1990s as a result of the convergence of their interest rates to the lower German level will disappear now that harmonised interest rates exist.

One must also add to this hitherto restrictive policy orientation of the ECB the fact that by pursuing this policy the bank is also intensifying structural and regional asymmetries. This occurs firstly because despite convergence there has not yet been complete synchronisation of the economic cycle in the euro zone, and secondly, because the member states of the EMU show widely varying growth trends. This means that the ECB is obliged to use one single instrument – variation of its key interest rate – across an economic area which still has significant variations in growth rates, unemployment rates and inflation rates (Arestis et al. 2002).[11] For this reason alone, the ECB policy produces asymmetrical effects which are in turn intensified by virtue of the fact that the transmission channels for monetary policy in the member states also vary widely on account of them having capital markets and commercial banking systems which still differ considerably (Cecchetti 1999, Mihov 2001).

2.2 Fiscal policy

In the context of the ECB's aggregate restrictive and both structurally and regionally asymmetrical monetary policy there is currently no possibility of a compensating fiscal policy at EMU level. The European Union (EU) budget amounts to a maximum of 1.2% of GDP in the EU, it must be balanced each year and is largely used for the Common Agricultural Policy – only a small part of it is available for the Cohesion and Structural Funds. Under such circumstances, therefore, the EU budget is unable to function either as an economic stabiliser or to be used to combat structural or regional asymmetries (Arestis et al. 2001). This means

[11] This means that the EMU's largest country, Germany, which has the smallest GDP growth rate and the lowest rate of inflation, faces the highest real rate of interest in the euro zone – a factor which retards growth even further (Hein/Truger 2004a).

that fiscal policy remains essentially a matter of national responsibility and is co-ordinated through the Treaty of Maastricht and the Amsterdam Stability and Growth Pact (SGP) (European Commission 2002). As conditions of entry to the monetary union, the Maastricht Treaty sets a maximum deficit ratio (proportion of current budget deficit in relation to GDP) of 3% and a maximum debt ratio (proportion of public debt in relation to GDP) of 60%. The SGP makes this regulation even tougher by prescribing for the medium term, i.e. a time span which stretches across economic cycles, balanced budgets or budget surpluses in order to reduce the level of debt.[12] Achieving these conditions is intended, on the one hand, to enable the budget sufficient scope to allow the automatic stabilisers to work during economic downturns without violating the 3% deficit criterion. On the other hand, it should create leeway for any future funding objectives which may arise, especially from demographic developments such as social security provision for the elderly.

There is just as little provision in the SGP for the loan financing of public investments as there is for the medium-term use of budget deficits to stabilise effective demand at a level that is compatible with a high level of employment. The latter implies that a balanced budget in each country must be compatible with every level of employment, including a level of employment which is determined by the supply side e.g. via the NAIRU (Arestis/Sawyer 2003). As we know from macroeconomic accounting, a country's private savings (S) minus investments (I) is equal to the sum of its exports (X) minus its imports (M) plus government expenditure (G) minus tax revenues (T): $S - I = X - M + G - T$. In the case of a balanced budget, domestic surplus savings must be equal to the export surplus. There are no adjustment mechanisms, however, to achieve this for a given level of employment. Even if a neo-classical interest rate mechanism is assumed to adjust investment and savings, this will have little effect for the individual countries in a monetary union where there is an integrated capital market. The same is true for the balance of exports and imports which is supposed to be achieved via the exchange rate according to the neo-classical theory of international trade, since the exchange rate no longer exists between the member states of a monetary union, and between the monetary union and other currency areas it is not determined by the export surplus of any individual country in the monetary union. There is therefore no reason to suppose that for a given level of production and employment, and with decentralised decision-making by companies and private consumers with regard to investments and savings, the

[12] See Allsopp/Vines (1998), Arestis et al. (2001), Eichengreen (1998) and Semmler (2000) for a more detailed analysis of the SGP.

budget will always be balanced. Under these circumstances, the balancing of the budget forces either an expansion of export surpluses (or a reduction of export deficits) or a cut in domestic surplus savings. The latter, assuming a stable savings-income ratio, implies a Keynesian-style decrease in domestic employment, whereas the former implies domestic wage restraint with a view to improving international price competitiveness, which cannot, however, go unanswered by competitors within a monetary union, and may therefore trigger a disinflationary and ultimately deflationary process.[13]

The co-ordination of fiscal policies in the framework of the SGP requires member states to present annual stability programmes to the European Commission which describe how they intend to achieve balanced budgets and which can be employed as early warning systems to give advance notice of when a country is approaching the 3% limit for its current budget deficit. If this mark is overstepped, the 'excessive deficit procedure' comes into operation (EC Treaty, Art. 104). If the country is not in a deep recession, defined as an annual fall in real GDP of more than 2%, and if the country in question refuses to put consolidation measures in place, penalties of up to 0.5% of GDP may ultimately be incurred. These financial penalties thereby raise the deficit to be consolidated.

It is clear from this brief outline that the decentralised fiscal policy of the EMU is also hardly in a position to compensate for the restrictive and asymmetrical effects of the ECB's monetary policy, indeed if anything it reinforces them. The lack of fiscal federalism makes it impossible to combat regional and structural asymmetries. Even in the case of a widespread symmetrical recession, the decentralised fiscal system does not encourage co-ordinated anticyclical measures; on the contrary, it supports a tendency towards free-riding. National fiscal policies committed to budget consolidation in their stability programmes, will wait for the spill over effects of the active fiscal policies of other EMU member states or other parts of the world, such as the USA. This 'prisoner's dilemma' means that public expenditure will tend to be procyclical and the automatic stabilisers will be negated.

[13] The proposal by Allsopp (2002) and Allsopp/Artis (2003), to facilitate budget consolidation in Germany with a structural domestic surplus saving by further raising export surplus by means of a deflationary wages policy, cannot therefore be supported, because on the one hand such a policy holds the risk of a wage dumping process within the EMU, and on the other the German economy, which is currently experiencing a stagnant GDP development, a rate of inflation below the EMU average, an already high level of export surplus and a weak level of domestic demand, would come closer to deflation. On current deflation risks in Germany see Hein/Schulten/Truger (2004).

Empirical studies show that fiscal policy in the EMU member states during the EMU convergence process of the 1990s was appreciably more restrictive than in the 1980s (see Figure 3a). The structural deficit ratio was reduced several times during a downturn phase and thus the measures taken were actively restrictive (Hein/Truger 2004). In addition, the consolidation introduced on the expenditure-side was in particular at the expense of public investment and hence future growth opportunities. The average annual growth rate of public investment in the EMU countries (excluding Greece) in the 1990s was –0.5%, whereas in the USA it was running at 3.2% (Truger 2002). Consequently, in the second half of the 1990s public investment as a percentage of GDP fell to 2.5% in the EMU states, having stood at between 3% and 4% in the 1970s and remained well above 3% throughout the 1980s. In the USA, on the other hand, the public investment ratio stabilised in the second half of the 1990s at a level well above 3%.

During the first three years of monetary union, fiscal policy in the EMU was overall moderately expansive, and the structural budget deficit ratio increased by roughly 0.8% (Figure 3a). Between 1999 and 2000, this expansion ran into a phase of economic upswing and thus had a procyclical effect. In the downturn which began in 2001, the expansion initially had a slightly anticyclical effect in line with the economic situation. However, by 2003 at the latest, fiscal policy was clearly constrained by the limits of the Stability and Growth Pact, and in spite of a further fall in the output gap, 2003 saw a return to a restrictive policy. Given the current prolonged stagnation phase, during which the two largest EMU countries, Germany and France, are being forced to take further active consolidation measures as part of the deficit procedure, 2004 is also set to see restrictive fiscal stimuli[14] which will further destabilise the economy (IMF 2003). Fiscal policy in the USA, on the other hand, was much more expansive and in tune with the economic circumstances (Figure 3b). In the US, the structural deficit ratio was cut sharply during the long upturn of the 1990s, but after the economic downturn of 2001 emphatic anticyclical measures were taken once more. Almost the same development has taken place in the UK since the early 1990s (Figure 3c).

[14] For Germany, fiscal policy planning for 2004 and 2005 is already restrictive (Institute 2003).

Figure 3a: Output gap and structural budget deficit in the EMU, 1980-2003 (in % of potential GDP)
Source: OECD (2003)

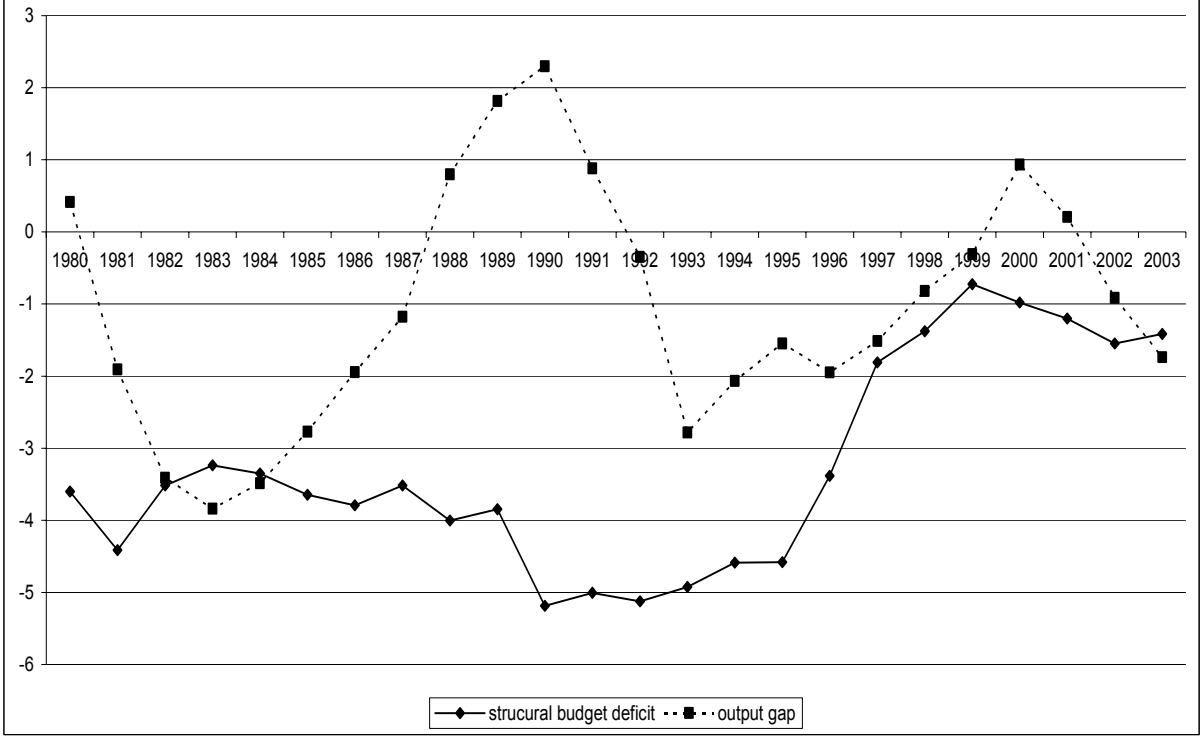


Figure 3b: Output gap and structural budget deficit in the US, 1980-2003 (in % of potential GDP)
Source: OECD (2003)

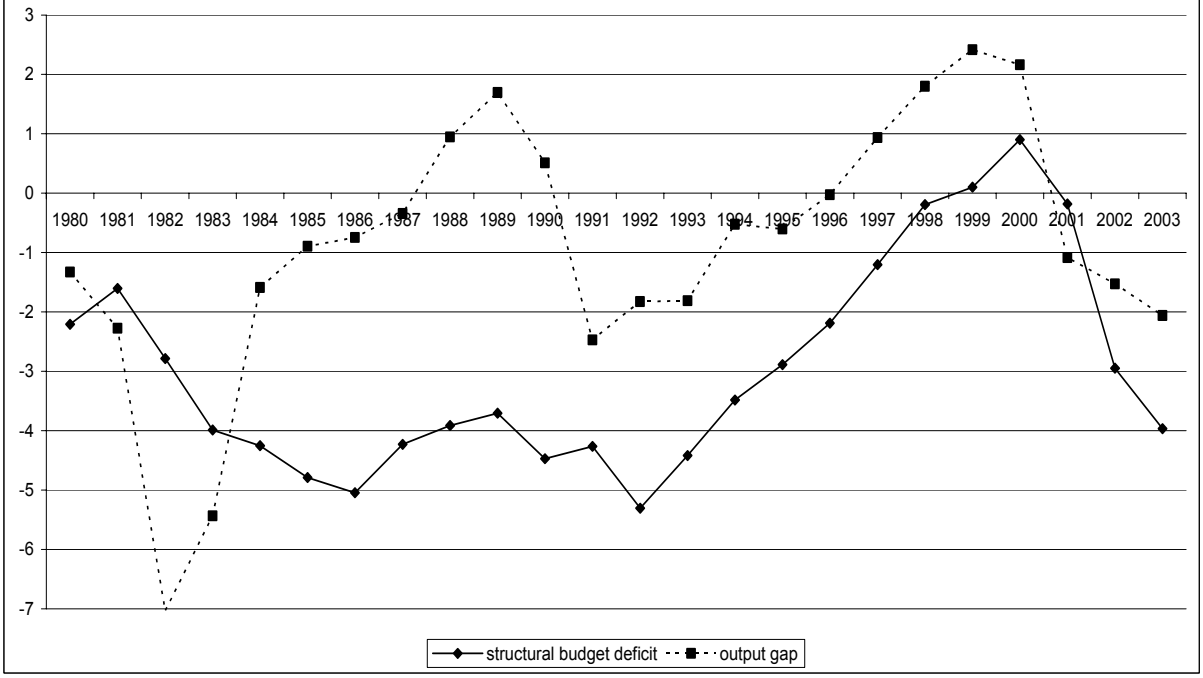


Figure 3c: Output gap and structural budget deficit in the UK, 1980-2003 (in % of potential GDP)
Source: OECD (2003)

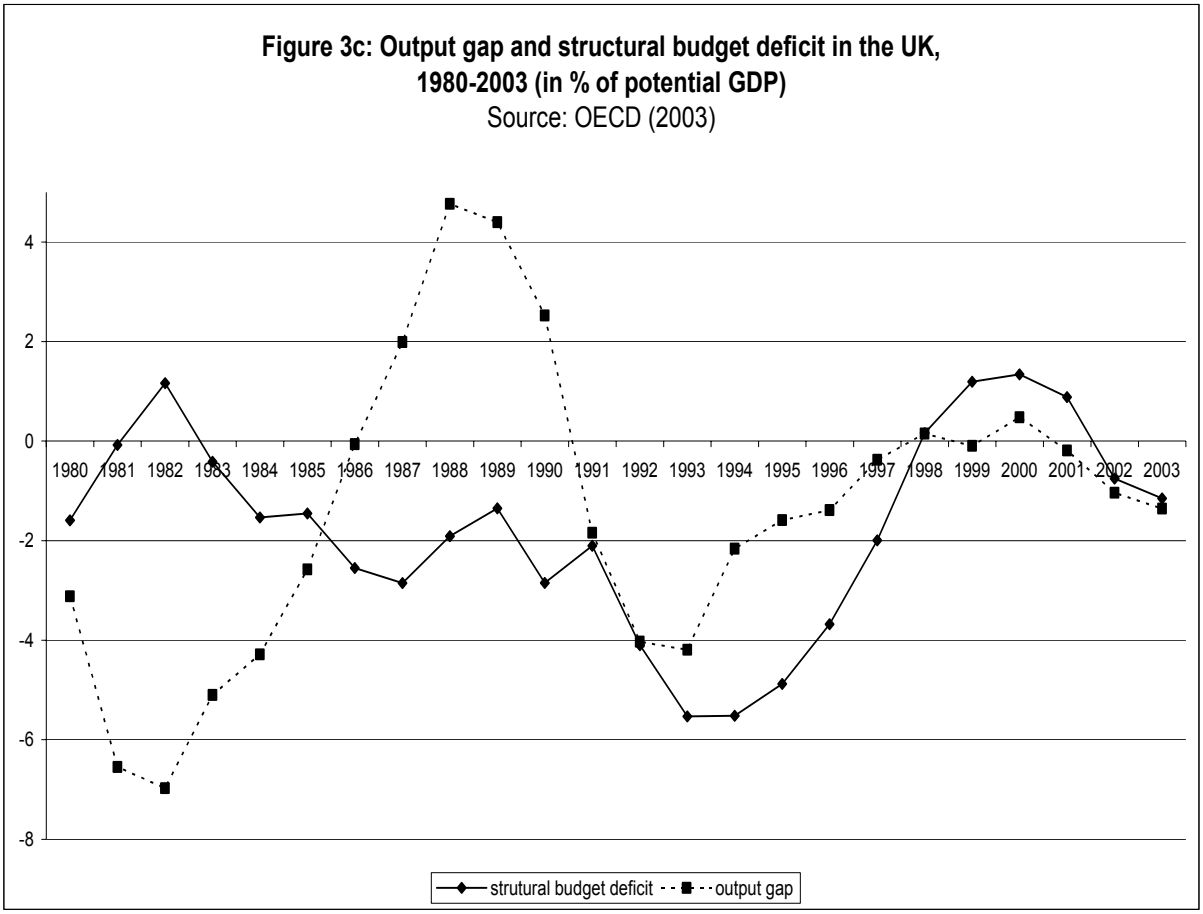


Table 4: Variation in national output gap and structural budget deficit (as % of potential GDP) from 2000 to 2003 in EMU countries, United Kingdom and USA.

	Variation in output gap	Variation in structural budget deficit
Belgium	- 3.9	2.3
Germany	-3.3	-0.6
Greece	2.0	0.0
Spain	-1.9	1.3
France	-2.4	-1.1
Ireland	-3.6	-4.3
Italy	-2.2	0.4
Luxembourg	--	--
Netherlands	-5.2	0.4
Austria	-4.2	1.8
Portugal	-4.8	2.0
Finland	-3.7	-1.6
EU 12	**-2.7**	**-0.4**
United Kingdom	-1.8	-2.5
USA	-4.2	-4.9

Source: OECD (2003)

Although the general decline in the public investment ratio within the EMU has not continued since the start of monetary union, most member states experienced a clear procyclical fall in their public investment growth rate during the downturn of 2001 (OECD 2003). The SGP therefore made no contribution to increasing the stability of public investment.

A disaggregated appraisal of the fiscal reactions to the economic downturn since 2001 in the individual states only serves to highlight further the inappropriate nature of fiscal policy in the EMU given the economic situation. It also highlights very clearly the problem of free-riding. Table 4 compares the variation in the output gap between 2000 and 2003 with the variation in the structural budget deficit ratio. Out of all the EMU member states, only Ireland pursued an emphatically anticyclical fiscal policy, with a sharp fall in the output gap of 3.6% leading to an increase in the budget deficit ratio of 4.3 percent. Along with Finland, only the two largest countries, France and Germany, pursued a moderately anticyclical policy throughout the crisis years, although it appears likely that this will be moderated or even reversed in 2004. All the other countries attempted to balance their budgets as prescribed by the SGP, and in so doing pursued a fiscal policy which served overall to exacerbate the crisis causing them in fact to become free-riders in terms of the economic cycle. If Germany and France had reacted similarly and also made extensive cuts to their structural deficits in order to comply with the terms of the Stability and Growth Pact, the EMU might well have been thrown into deep recession. Fiscal policy in the United Kingdom and the USA, on the other hand, where powerful measures were introduced to counteract the downturn, was used in exemplary fashion.

Even the recent reforms adopted by the ECOFIN Council at the behest of the Commission do little to alter the restrictive and rather growth-unfriendly nature of fiscal policy in the EMU (ECOFIN 2003). Alongside a number of very general appeals to allow the automatic stabilisers to operate symmetrically, i.e. even in an upturn, and to keep an eye on the sustainability of public finances when evaluating consolidation progress, all the ECOFIN Council does is specify that the call for a balanced budget or budget surplus should relate to the cyclically adjusted budget position. Countries which have not yet met this requirement should reduce their structural deficit ratio by 0.5% per annum, despite the current weakness of the economy. This has already led to a situation in which the countries in question, i.e. Germany and France in particular, are not in a position to allow the automatic stabilisers to take full effect.

2.3 Wages policy

In the context of a single monetary policy geared exclusively towards price stability, and a fiscal policy committed to supercyclical budget consolidation, the prevailing view is that the real wage determination is the key factor for determining the level of production and employment and for assimilating symmetrical and asymmetrical shocks. Correspondingly, there is no shortage of proposals aimed at increasing wage differentials, further deregulating the European labour market, decentralising the wage bargaining systems, reducing the reservation wage arising from wage-compensating benefits, and promoting an active labour market policy geared towards improving the qualifications and mobility of the labour supply. In this view, the high level of unemployment in Europe can predominantly be put down to 'structural' reasons, and monetary integration is often seen as the catalyst for the long heralded structural reforms (e.g. Calmfors 1998, Issing 2002). This position has shaped key areas of the common economic policy agreed on either by the EU or the EMU (European Commission 2002). For example, such demands are a recurring feature of the Broad Economic Policy Guidelines adopted by the European Council (EC Treaty, Art. 99). Likewise, the employment chapter of the Amsterdam Treaty (EC Treaty, Art. 125-130) and the annual employment guidelines (under the 1997 Luxembourg Process) seek to improve the efficiency of the labour market in order to eliminate high unemployment in Europe.[15]

However, this emphasis on structural reforms in the labour market and the wage bargaining systems ignores the fact that these measures only have an impact on nominal wages determined on the labour market, and not on real wages, if we realistically assume that in imperfect commodity markets, prices come about as a result of a mark-up being added to unit labour costs. For this reason, downward nominal wage differentiation and general wage restraint initially have an effect only on prices, and can only exert a possible influence on growth and employment if the ECB rewards this wages policy with a symmetrical and consequently more expansive monetary policy (Allsopp/Vines 1998). What is required in order for a reduction of the NAIRU, which should arise from structural reforms in the labour market, also to result in a lowering of the actual unemployment rate, is an employment and growth-oriented monetary policy which stimulates investment and effective demand. However, as outlined above, such a strategy has not been pursued by the ECB since 1999.

[15] At the heart of the employment guidelines is the promotion of employability, entrepreneurship, labour market flexibility and equal opportunities for women.

But the pursuit of a strategy aimed at reducing unemployment in Europe by deregulating the labour market and decentralising wage bargaining entails a further risk. It must not only rely on a symmetrical central bank reaction function, but also on monetary policy having a symmetrical effect, or on a real balance effect which guarantees to close the gap between the demand for goods and the supply of goods linked to the NAIRU (Hein 2004). For such a real balance effect we must assume the dominance of an exogenous money supply which represents a net asset for the economy as a whole. However, when money arises from creditor-debtor relationships in a modern two-tier banking system, this is not the case. In an economy such as this, monetary policy is also relatively unlikely to have symmetrical effects. In the short term, monetary policy may be able to choke a cumulative inflationary process caused by excessively low unemployment by applying the interest rate brake, thus curbing effective demand for goods and increasing unemployment. However, if during a recession unemployment rises significantly above the NAIRU, leading to disinflation and ultimately deflation, then an interest rate cut is not enough to stimulate an economic recovery, when companies have depressed profit expectations and are affected by debt deflation.

Macroeconomic wage externalities can be internalised more effectively by taking a macroeconomic approach to co-ordinating wages policy in which nominal wage growth rates are determined on the basis of the sum of long-term productivity growth for the economy as a whole and the central bank's inflation target.[16] This firstly means that 'effective co-ordination' of wage bargaining is able to reduce inflationary pressures when employment is rising and in so doing to lower the employment limit expressed in the NAIRU.[17] Such a course makes it possible for the central bank to tolerate a higher level of employment while still meeting its inflation target. Secondly, during a phase of rising unemployment, co-ordinated wage bargaining can lessen the pressure for wage reductions and thereby reduce the risk of macroeconomically destabilising deflationary processes.

[16] This has been shown recently in a series of works on the interaction between wage bargaining systems and independent central banks. Franzese (2001), Soskice/Iversen (2001) and Hein (2002a) each present overviews containing implications for the EMU.

[17] What is meant here by 'effective co-ordination' of wages policy is a functioning horizontal co-ordination between the sectors of industry which is accompanied by a functioning vertical co-ordination within the sectors (Kittel/Traxler (2001)), which solves the problem of implementation and prevents earnings drift and wage dumping.

There are, however, considerable obstacles standing in the way of an EMU-wide co-ordination of wages policy. National wage bargaining systems still vary widely, for example, although they show a much greater degree of national co-ordination than in the United Kingdom or the US (Borghijs et al. 2003, Hancke/Soskice 2003). Against this backdrop, there have been various attempts on the part of the European trade unions to co-ordinate wages policy transnationally (Schulten 2002). In the 1998 Doorn declaration, the trade union federations of Germany and the Benelux countries agreed to pursue productivity-based real wage increases in order to prevent tit-for-tat wage dumping between countries. At a sectoral level, the European Metalworkers' Federation was the first to adopt the concept of European wages policy co-ordination based on productivity increases and the inflation rate. This concept has since been adopted by almost all the industry federations and by the European Trade Union Confederation. However, the co-ordinated implementation of such an approach is on the one hand hampered by the sustained pressure for the decentralisation of wage bargaining. This trend follows the decentralisation of corporate decision-making and is strengthened by increased global competition and the increasing dominance of the employer side. Furthermore, in a phase of sluggish growth, social pacts which attempt to strengthen the international competitiveness of the domestic economy through nominal wage restraint[18] have become increasingly widespread throughout Europe at the national levels. Both these tendencies stand in the way of an effective EMU-wide co-ordination of wages policy.

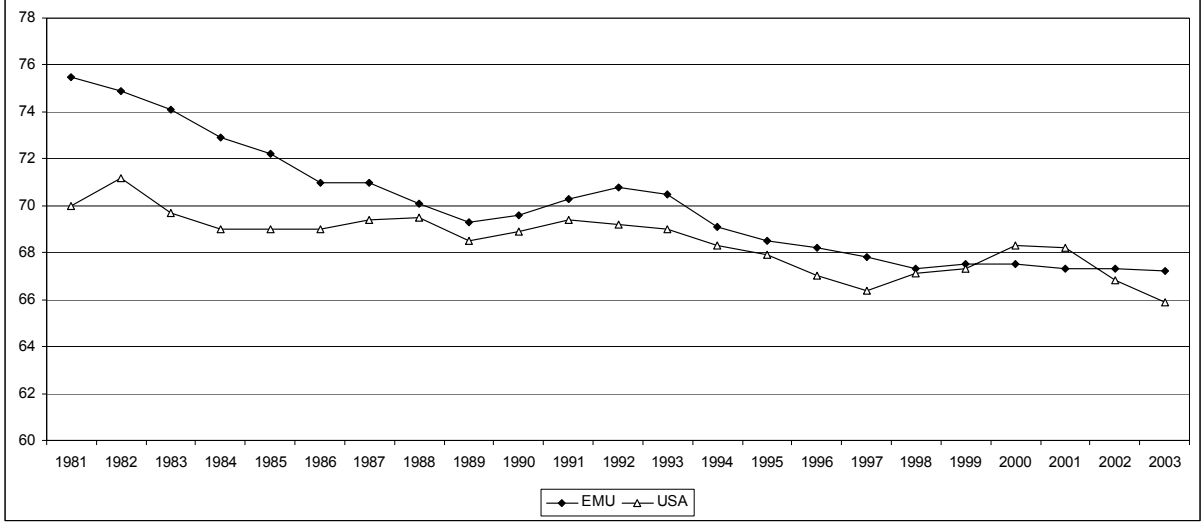
The lack of EMU-wide co-ordination of wages policy and the trend towards national corporatist competitive structures are having negative repercussions on macroeconomic performance. In phases of rising employment or when there are negative external shocks which restrict the scope for income distribution, it is not possible to achieve the necessary nominal wage restraint and the ECB may as a result be forced to intervene and cause unemployment to rise.[19] In phases of high unemployment, such as at present, countries with a high degree of national wage bargaining co-ordination can exploit this advantage to

[18] See on this subject e.g. Calmfors (2001) and Schulten (2002a). According to Calmfors (2001) when the EMU was introduced there were national pacts aimed at improving international competitiveness in the following countries: Belgium, Germany, Greece, Finland, Italy, Ireland, Netherlands, Portugal and Spain.

[19] Astonishingly, Hancké/Soskice (2003) see here the main danger arising from EMU wages policy, resulting from there no longer being a central wage policy player to stand up to the ECB, unlike was previously the case with the Bundesbank and the IG Metall. As evidence for the risks which this situation poses to stability they point to the long periods during which the inflation rate in the EMU rose above the target rate, without however posing the question where the causes of these missed targets might be found. In circumstances of general wage restraint, therefore, they recommend a co-ordinated effort on the part of the trade unions in Germany, France and Italy towards further wage moderation in exchange for state-sponsored initiatives with the aim of improving growth in productivity.

strengthen their price competitiveness by means of nominal wage restraint within the framework of social pacts. Such competitive corporatism poses a danger when it is pursued by several countries, especially large ones, since it causes deflationary pressure to be exerted on the euro zone as a whole. General nominal wage restraint and falling wage shares brought about by downward commodity price rigidities then contribute to macroeconomic destabilisation. Figure 4 shows the long-term effects of deflationary nominal wage pressure on the labour income share, which followed a downward trend in the EMU countries from the early 1980s on, then fell sharply during the convergence process in the mid 1990s and has remained almost stable since 1999, i.e. in 2001/2 it did not rise again, as would be usual in a period of weak economic activity. This last fact points to greater downwards flexibility of nominal wages, which thus cease to act as stabilisers during economic downturns. In the US, on the other hand, a similar – if not quite so marked – downward trend in the labour income share could be observed from the beginning of the 1980s, but this was halted by the mid 1990s. In the 2000/2001 recession the wage share rose sharply, before falling back again in the ensuing upturn.

Figure 4: Labour income shares in the EMU and the US, 1980-2003 (in %)
Source: European Commission (2003)



2.4 An overall restrictive policy mix

Summing up, the EMU is dominated by an overall restrictive policy mix which has already been responsible for the low growth, the high unemployment and the inadequate real convergence witnessed in the 1990s.[20] The ECB's monetary policy, the primary goal of which is to create price stability, exhibits a clear 'anti-growth bias' and has considerable asymmetrical effects on the countries of the euro zone. There is a danger that the restrictive and asymmetrical effects of such a monetary policy will become even more apparent in future, since the compensating expansive effects of the general interest rate convergence to the lower German level are disappearing now that there is a single interest rate. Without mature fiscal federalism and with the restrictions imposed on national fiscal policy by the SGP, there are no fiscal instruments to counteract regional and structural asymmetries and to stabilise the macroeconomy in a recession, especially if the ECB continues to stick to the letter of its remit as it has done in the past (Spahn 2003). Given that the larger countries, in particular, are now threatening to exceed the limits imposed by the SGP and have been forced to adopt a markedly procyclical fiscal policy, what one might actually expect from fiscal policy is an additional restrictive effect. Inadequate EMU-wide co-ordination of wages policy in combination with further deregulation of labour markets, decentralisation of wage bargaining and the dominance of national competitive corporatist structures reinforces deflationary tendencies and real divergence. As the euro zone is essentially a large closed economy, the improvement of international competitiveness linked to these deflationary tendencies and the associated rise in export surpluses can only ease the strain to a very limited extent.

3. The alternative of a co-ordinated macropolicy and the scope for its implementation in the EMU

3.1 The concept of a co-ordinated macropolicy

One alternative to the 'new monetarist' policy approach and assignment is a (post-)Keynesian approach which could form the basis for a more expansive, employment-oriented

[20] For more on the restrictive policy mix of the EMU convergence process, see for example Bibow (2001), Lombard (2000) and Semmler (2000).

macropolicy. The essential characteristics of this approach can be summarised under the following four points:[21]

1. In a money economy, Say's Law and the classical dichotomy between the monetary and the real spheres do not apply either in the short or the long term. The private sector is unstable and is therefore in need of a policy stabilising effective demand in the short and long term. In order to do this, what is required is a co-ordinated monetary, fiscal and wages policy geared towards the medium to long term.

2. In the short term, the central bank's interest rate policy influences effective demand, and in particular private investment, via delayed effects on the capital market interest rate, and in the long term it affects functional income distribution. Monetary policy therefore has considerable real effects in the short and long term. Its short-term effects are asymmetrical, however: by raising interest rates the central bank can put a stop to any boom, but cutting interest rates when businesses have depressed profit expectations cannot end a recession. To do this it requires the support of fiscal and/or wages policy.

3. The nominal wages policy agreed by the social parties has no direct influence on employment. Instead, it influences the nominal unit labour costs for a given level of labour productivity and the price level for a given mark-up applied by businesses when setting prices. Changes to distribution are only possible if this is allowed by the factors that influence the mark-up, such as the intensity of competition on the commodity markets or the long-term prevailing interest rate. The level of employment is a product of effective demand on the commodity market, the development of which is essentially determined by private investment, which is in turn dependent on the relationship between the expected profit rate and the interest rate.

4. Fiscal policy can stabilise the economic cycle in the short term by accepting cyclical deficits and surpluses, and in the long term it can increase effective demand and potential growth by means of a policy of investment-oriented borrowing. Moreover, the distribution of available income can be modified by means of tax policy and social policy, and this can in turn influence consumer demand which is the largest demand aggregate. Government competition policy influences the level of competition on the commodity market and also therefore mark-ups and functional income distribution.

[21] For more detailed information see Hein (1998, 2002), Hein/Truger (2002), Heine/Herr (1999, pp. 315-480).

On account of the interdependencies of the instruments used by the economic players and the fact that the target variables are in each case influenced by different instruments, the (post-)Keynesian approach prohibits a strict assignment of players and instruments to just one single economic policy goal. As a result, co-ordination of the means employed is indispensable. This co-ordination may be achieved implicitly by individual players taking account of the interdependencies, or it may be achieved explicitly in the framework of institutionalised ex ante co-ordination. What is vital, however, is that the players are aware of the interdependence of their activities and that there is agreement on the likely effects of the instruments used. As such, co-ordination requires a minimum level of consensus with regard to the analysis of economic circumstances, the diagnosis and prognosis for the economic situation and the economic objectives to be achieved (Priewe 2002).

The first objective of a co-ordinated macropolicy in a world where fundamental Keynesian uncertainties exist must be to stabilise the expectations of private investors by means of an economic policy focused on the medium to long term, which supports market configurations with stable effective demand and therefore in particular with stable private investment demand (Heine/Herr 1998). As part of a co-ordinated macropolicy, wages policy has the task of providing an anchor for price level stability by basing nominal wage growth on long-term productivity growth for the economy as a whole and on the central bank's inflation target. In this way it not only eases the pressure on monetary policy in the fight against inflation, but also prevents the occurrence of deflationary processes which would be damaging to the economy as a whole. Furthermore, a productivity-based wages policy ensures that consumer demand, as the largest demand aggregate, grows at roughly the same pace as output. In order to perform this task successfully, there must be a high degree of effective macroeconomic co-ordination of wages policy. If the pressure on monetary policy can be relieved by wages policy in this way, then monetary policy will be able to tolerate lengthier upturn phases with rising employment without having to provoke stabilisation crises. In addition, on account of its short-term asymmetrical effect and the considerable delay before the effects of using its interest rate instrument are felt, it also has the responsibility to react promptly to any incipient downturns in order to prevent deep recessions from coming about, where monetary policy is ultimately impotent. This requires a monetary strategy which provides for a symmetrical response when targets are not met, as well as taking into account growth and employment effects. In the long term, monetary policy should aim for a policy of low interest rates on account of its distribution effects, in order to prevent income redistribution in favour of asset

owners and in order to stimulate investment in real assets. Fiscal policy should on the one hand allow the automatic stabilisers to take effect and thus stabilise economic activity, but in so doing it should avoid destabilising discretionary interventions. On the other hand, fiscal policy should be able to use loan-financed public investment in infrastructure and human capital in order to stabilise effective demand for the long term and to raise productivity growth for the economy as a whole. Given a correspondingly high self-financing ratio achieved by higher growth and the pursuit of a low interest rate policy by the central bank, there will be no threat to the sustainability of public finances as a result of the loan financing of investments. A strengthening of private consumer demand should come about as a result of taxation and social policy boosting the disposable income of high-spending consumers in the lower income brackets.

3.2 Co-ordinated macropolicy in the EMU

The implementation of a co-ordinated macropolicy in the EMU will necessarily require the key players to reject the policy mix which has been applied until now. Moreover it faces institutional problems, since the current regulations for monetary and fiscal policy, as well as the conditions governing wages policy in the EMU, do not support a co-ordinated expansive macropolicy and indeed to some extent stand in its way. Over the pages which follow we shall briefly outline possible approaches in the EMU for achieving a more expansive policy mix, together with any necessary institutional reforms, for each of the individual policy areas and their co-ordination.

3.2.1 Wages policy

In order for wages policy to be able effectively to carry out its role as a nominal and real stabiliser as outlined above and not to exacerbate regional disparities, nominal wage growth in the individual member countries of the EMU should be aligned with long-term national productivity growth and the ECB's inflation target. Wage dumping between member states is therefore as much to be avoided as inflationary settlements which call for restrictive intervention from the central bank. No attempt should be made, therefore, to use wages policy to directly influence distribution or employment. For a nominally stabilising wages policy,

what is required is the effective co-ordination of wage bargaining not only nationally but also in particular at a transnational EMU level. These in turn require trade unions and employers' associations at national levels which are able to bargain and develop strategies effectively and are in a position to conclude and guarantee the implementation of settlements oriented towards the economy as a whole (Kittel/Traxler 2001). Key instruments to this end are sectoral collective agreements and the universal validity of collective agreements. The decentralisation of collective bargaining and promotion of individual company-level wage settlements recommended in the Broad Economic Policy Guidelines are as diametrically opposed to these requirements as a further deregulation of the European labour market. Although the European trade unions have now accepted that wage settlements should be based on productivity growth and the rate of inflation,[22] in almost all EMU member countries the national trade union organisations have also become involved in social pacts aimed at increasing national competitiveness by means of wage restraint, which place deflationary pressures on the euro zone as a whole. These national competitive corporatist structures also act as an obstacle to responsible macroeconomic co-ordination of wages policy in the euro zone.

In order to give wages policy in the EMU the opportunity to fulfil its role within a co-ordinated macropolicy, therefore, not only must there be a fundamental abandonment by economic policy of the current strategy of labour market deregulation and decentralisation of collective bargaining, but also increased efforts by the trade unions to achieve an effective European-level co-ordination of their wage demands are required (Schulten 2002a).[23] Until this happens, especially in periods of high unemployment such as at present, wages policy will create a deflationary pressure which gives monetary and fiscal policy a particular responsibility for growth and employment.

[22] What is meant here, however, is usually not the target inflation rate of the central bank but consumer price inflation. Implementation of such a wages formula may, of course, set off a cumulative inflation process for businesses applying cost-oriented price fixing, if the distribution demands of the state or other countries rise, e.g. as a result of an increase in the net tax and fiscal charge rate or in import prices (Hein 2002a).

[23] In the EMU, a co-ordination approach such as this must be based on existing national co-ordination mechanisms and should seek to network these transnationally. Such a decentralised approach might for example mean that the trade unions in the metalworking industry could take on the role of wage leadership in Europe. This would mean that the collective bargaining policy of Germany's IG Metall in particular would play a central role. See Traxler/Mermet (2003) on a similar approach

3.2.2 Monetary policy

In the context of a co-ordinated macropolicy, monetary policy also assumes responsibility for growth and employment, especially when there is no inflationary pressure from wages policy or fiscal policy. The ECB should therefore make much more fundamental changes to its monetary strategy than in the last review in May 2003, and formulate its inflation target as a point or corridor target which it can then aim for in a symmetrical fashion. The ECB might well use the monetary strategy of the Bank of England as a model. The Bank, which is otherwise independent, is currently charged with the task of achieving an inflation target of 2.5% prescribed by the Treasury. Deviations of one percentage point in either direction must be explained to the Chancellor of the Exchequer.[24] This means that, in contrast to what the ECB has done thus far, the central bank must not only combat upward deviations from its inflation target but must also combat downward deviations equally vigorously. Accordingly, the ECB's inflation target should be raised to at least the level set by the Bank of England, or perhaps even higher, in order to take into account the fact that the member states of the EMU have different long-term growth trends and accordingly different rates of inflation. Moreover, the target should really be treated as a medium-term goal, allowing the effects of supply shocks (e.g. energy price rises) to peter out, and only kicking in again if a cumulative price-wage-price spiral is triggered as a result. Furthermore, the ECB should keep a closer eye on growth and employment targets and from time to time test the growth potential of the euro zone by means of a controlled monetary expansion, along the lines of what the US Federal Reserve did in the second half of the 1990s (Allsopp 2002). Such a policy takes account of the fact that potential growth or the NAIRU are not exogenously determined variables, but are in fact jointly determined by actual real GDP and employment trends both of which are also influenced by monetary policy (Kaldor 1957, Hein 2004).

Should the ECB stick to its anti-growth and anti-employment course, then the legal framework would have to be changed in line with the above. However, any attempted amendment to the EC Treaty would be faced with major obstacles, since there would have to be agreement among all member states. The core of any such amendment should be the requirement for a medium-term inflation target set by economic policy (e.g. through the European Parliament) which the ECB should seek to achieve in a symmetrical fashion[25] as

[24] See Meyer (2001) on various monetary policy strategies.
[25] See Fitoussi/Creel (2002) for a proposal along these lines.

well as the elevation of growth and employment to monetary policy objectives with the same status as price stability. At the same time, monetary policy should be required to increase co-operation with the other policy areas, e.g. in the Macroeconomic Dialogue, but without encroaching upon the independence with which it chooses its instruments.

Even if a growth and employment-oriented realignment of monetary policy in the EMU were achieved, considerable macroeconomic instability risks could still be expected if a deflationary wages policy continued to be pursued and unemployment remained high. One issue is the asymmetrical and sometimes significantly delayed effects of monetary policy during the course of the economic cycle. Should there be a failure to react in time to an emerging downturn or a negative shock, allowing the economy to plunge into a deep recession, then monetary policy will be powerless to do anything about it. In addition, not even a more expansive monetary policy for the euro zone as a whole can take account of regional and structural asymmetries. So for both reasons, there has to be co-ordination with fiscal policy.

3.2.3 Fiscal policy

At present, any use of fiscal policy in the EMU to stabilise the economy, combat regional asymmetries and improve the long-term growth trend would contravene the regulations of the SGP.[26] Neither the super-cyclical target of balanced budgets or budget surpluses – and the concomitant asymptotic reduction of the debt-GDP-ratio to zero – nor the 3% limit on the current deficit have any reasonable economic justification as target figures. Moreover, the budget deficit is an endogenous variable of the whole macroeconomic process and cannot therefore be directly controlled by fiscal policy. However, the consolidation pressure imposed by the SGP is at its greatest at times of recession and forces the adoption of a procyclical fiscal policy with its particularly negative effects on public investment, whereas there are no consolidation regulations for economic booms.

Nevertheless, co-ordination of national fiscal policies in the monetary union is necessary in order that the automatic stabilisers can be allowed to take effect in economic downturns, to

[26] Even the most recent reforms adopted by the ECOFIN Council have brought no fundamental improvement, as already explained above.

avoid free-riding by individual member states, and to prevent inflationary budgetary behaviour by individual member states during economic booms. As part of a co-ordinated fiscal policy in the EMU, therefore, individual countries should be obliged to allow the automatic stabilisers to operate symmetrically, i.e. during both downturns and upturns.[27] To this end, as an alternative to the SGP the individual countries should in our view establish expenditure paths for non-investment, non-cyclical spending, which would be financed in the long term by current tax revenue. Cyclical spending should then be allowed to float freely around this target without being constrained by budget deficit limits. In a downturn, increases in expenditure and falls in revenue bring about budget deficits which are financed by borrowing, thus increasing the level of debt. In an upturn, on the other hand, budget surpluses are created, which are used for consolidation purposes. If non-investment, non-cyclical spending grows at a higher rate than the nominal production potential, then the result is rising super-cyclical budget deficits, whereas if it grows at a slower rate, then structural deficits are reduced. Alignment of the expenditure path with a growth rate below that of the nominal potential GDP path can therefore contribute to a revenue-side budget consolidation, if a structural deficit requiring consolidation existed at the outset.[28]

For public investment, the possibility of loan financing should exist as a matter of principle (the Golden Rule). Each member country of the EMU should therefore be able to decide for itself on the level and financing of public investment. Even if the other current SGP regulations were maintained, this alone would be enough to mean that consolidation pressure would no longer continue to force down the level of public investment (Blanchard/Giavazzi 2003). Member states could use public investment to stabilise long-term effective demand at a level compatible with high employment (Allsopp 2002). Public infrastructure investment could be used to increase potential growth and to accelerate the closing of the productivity gap between countries.

In the context of a modernised stability pact, both the expenditure paths for non-investment, non-cyclical public spending and the level of public investment should be a matter for co-ordination and agreement between member states. With regard to public investment, government deficits should not be allowed to lead to an overloading of the production

[27] See Fitoussi/Creel (2002) on a similar proposal to that outlined here. Buti et al. (2003) give an overview of a series of reform approaches which for reasons of space cannot be discussed here.

potential and thus to inflationary pressures. Should such a situation arise – which is relatively unlikely, given the current under-utilisation of production capacity – then the country in question would be obliged to cut public investment accordingly or to finance such investment in part through tax revenues. In addition, under a modernised stability pact there should be checks to ensure that individual countries comply with the prescribed expenditure paths for non-investment, non-cyclical public spending. Moreover, the appropriateness of these expenditure paths themselves should also be subject to regular review, since the reference variable, i.e. the nominal potential GDP path, is liable to change as a result of public and private investment activity.

From time to time, the criticism has been made that expenditure paths imply a very specific concept of the desirable public spending ratio (Buti et al. 2003a, p. 104) and that they therefore restrict national governments' room for manoeuvre. However, it should be pointed out that in the context of the concept presented here, firstly the paths established are country-specific, so that there is no danger of the solution being too uniform. Secondly, the paths approach does actually allow for changes to the public spending ratio. In this case, however, an increase in the public spending ratio would have to be financed through additional taxation. A reduction in the public spending ratio – something which we would view with some scepticism – would be possible by lowering the expenditure path. Although this would have the effect of increasing the average restrictiveness of fiscal policy, the adjustment would nevertheless be smoothed out and the automatic stabilisers would be able to continue operating around the lower path. Furthermore, unlike most of the other approaches that have been considered, the expenditure path concept has the advantage that it can also be applied in the current situation and could significantly ease the current economic problems of Germany and France, the two countries which at present are particularly restricted by the SGP, without abandoning the goal of medium-term consolidation.

3.2.4 Co-ordination of wages, monetary and fiscal policy

An alignment of monetary and fiscal policy in the manner discussed, together with a re-orientation of wages policy, would constitute a move away from the restrictive 'new-

[28] This formed the basis for the process of budget consolidation in the US of the 1990s (Horn/Scheremet 1999). On a similar proposal for Germany see Bartsch et al (2002) and Eicker-Wolf/Truger (2003).

monetarist' policy mix and would lead to implicit co-ordination insofar as the interdependencies in economic policy making would be taken into account. This could therefore make a considerable contribution towards stimulating growth and reducing unemployment in the EMU. However, since a co-ordinated macropolicy requires a minimum of agreement between the players on economic causalities, the diagnosis and prognosis of the economic situation and on the goals to be pursued, the effectiveness of any such co-ordination could be increased significantly if there were an explicit ex ante agreement among the players regarding the means to be used. The appropriate institutions for this already exist within the EMU in the form of the Broad Economic Policy Guidelines and the Macroeconomic Dialogue. As a forum where a consensus could be achieved between the monetary, fiscal and wages policy players, the Macroeconomic Dialogue could be given a leading role in shaping the BEPG which would serve as the key instrument for a true macroeconomic policy co-ordination in the EMU.

4. Conclusion

This contribution traces the euro zone's inadequate macroeconomic performance in recent years back to the predominance of a restrictive macroeconomic policy mix based on a 'new monetarist' approach to economic policy. A co-ordinated macropolicy approach based on a (post-)Keynesian analysis was presented as a growth and employment-oriented alternative to this restrictive policy mix.

The implementation of a co-ordinated macropolicy geared towards the promotion of growth and employment within the EMU requires a fundamental break with the policy mix pursued hitherto. It calls for a fundamental move away from a policy which pursues structural reform of the labour market and differentiation and decentralisation of wage bargaining structures, promoting instead the creation of conditions which will better enable trade unions and employers' associations to act strategically so that they are able to take into account the macroeconomic role of wages policy. For the unions, this policy approach would involve largely abandoning attempts to use wages policy for distributional or employment policy ends. Rather, it would be necessary to gear collective bargaining policy towards EMU-wide co-ordinated nominal stabilisation. Since it will at best only be possible to achieve effective implementation of such a reorientation of collective bargaining policy in the long term, given

the widely differing national labour market institutions and the very national orientation which still exists with regard to wages policy, in the short term this means that the key goal must be a re-orientation of monetary and fiscal policy. As these both have a considerable effect on employment and income distribution, the European trade unions should strive to increase significantly the degree of influence they have on policy-making in these areas.

First and foremost, greater pressure must be brought to bear, by the trade unions as well, to force the ECB, as the main culprit responsible for the current stagnation, to abandon its 'anti-growth bias' and fundamentally alter its monetary policy strategy. The inflation target must be raised and pursued in a symmetrical fashion. Moreover, full exploitation of potential growth should be included as an additional goal of monetary policy. Should the ECB be unwilling to accept such a re-orientation, then the fundamental principles of monetary policy set out in the EC Treaty should be modified to the effect that EMU economic policy decision-makers would set monetary policy an inflation target to be pursued symmetrically, although it would continue to enjoy independence with regard to the instruments used to achieve this target. Furthermore, growth and employment should be established alongside price stability as equal-ranking monetary policy objectives. As far as fiscal policy is concerned, the SGP regulations must be modified so as to allow for investment-oriented public debt on the one hand (Golden Rule), and on the other the replacement of deficit targets with expenditure paths for non-investment, non-cyclical public spending. This will ensure that the automatic stabilisers operate symmetrically.

This new orientation of individual policies will require co-ordination of the instruments used, in the sense that macroeconomic interdependencies will have to be taken into account. The effectiveness of this implicit co-ordination can be strengthened by turning the Macroeconomic Dialogue into a genuine forum for promoting consensus among the players with regard to economic causalities, the diagnosis and prognosis of the economic situation, the goals to be pursued and the means to be deployed. The Broad Economic Policy Guidelines jointly agreed on by the Macroeconomic Dialogue could then become an instrument for implementing such an explicitly co-ordinated macropolicy within the EMU.

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